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Corporate Capitalization and the Economic Cycle

Background, History, and Constitutionality of the Federal Income Tax

The Theory and Practice of Collective Bargaining

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Financial Records in the Local Governmental Units of Illinois

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THERE IS one business in which you and every other man, woman, and child have an interest. Whether you are a day laborer, a retail store operator, a wholesaler, a manufacturer, or a professional man, you are a partner in this business. Of course, the business is government. You cannot move without being affected by this business. You awake in the morning having been protected from fire and theft by fire and police departments which you help to support. You walk or ride to work on streets which you help to build. Many of your daily actions are regulated by governmental officials whom you pay and help to select directly or indirectly. Your children go to schools administered by persons of your choice—schools financed by you. As you return home at night, the streets are lighted, but you are paying for the system and the current. You are helping to support this business. You have a financial interest in it. Is it being operated efficiently?

Local governmental units in the United States are spending over seven billion dollars a year. The local units of which you are a constituent are spending their share of this seven billion dollars. Are you getting fair value for the dollars you are putting into them? When you have an interest in any business and such a question arises, you rely on reports which have been prepared from adequate records kept of its day-by-day transactions. You would hesitate to invest in any venture if such records were not kept. Your business would be watched carefully and checked on by proper records kept by efficient and competent employees. The incompetent employee would be as much of a hazard to you as the dishonest one. Inadequate records would not be countenanced by you.

We hear much about graft in local government, but more losses occur through inadequacy of records and incompetency of employees than through dishonesty. The sooner each of us comes to the realization that our individual effort and our demands for records that will disclose inefficient operation are effective, the sooner will we have governmental units operated on the same basis that we would operate our own businesses. We will have records that show us what is being done, that show us where improvements can be made, records that give us, from a financial point of view, better and less expensive governmental units.

All of this seems to presume that our governmental units do not have

proper control through records. Of course there are exceptions, but in general the statement is true. Let us look at some of the facts. A proper system is divided into four parts: budgeting, accounting, auditing, and reporting. In discussing these various parts of an adequate system of control, their own merits will be emphasized. In many cases, certain legal requirements must be met. In some cases the law is good; in others, it is not. Sometimes the law is enforced; sometimes it is not. In any event, proper systems should be maintained not only because the law requires it, but because they have value in themselves. If proper systems are demanded by the constituency, such systems will eventually be required and enforced by law. The first consideration should not be political expediency, but proper and efficient management. Such systems should exist and flourish on their own merits, not because of legal requirements. The second will naturally follow the first. Is this idealistic? Not unless we refuse to accept the fact that we do operate our own governments, that we must not be apathetic about this problem.

A budget is a plan. It is the "key instrument of financial control." The theme of the budget is the estimate of revenues and expenditures for the coming fiscal year. The accuracy with which such documents may be prepared is great, when they are planned with honesty and judgment. They may be of great or little value, depending upon the thought and effort that is expended in their preparation. Theoretically, a governmental budget is prepared by determining what expenditures will be necessary and then setting the revenues to meet these expenditures. Practically, the problem may not be so easy. Many local units are limited in the revenues which may be obtained, hence the expenditures are frequently governed by the possible revenues. The revenues and expenditures must be worked out together. The expenditures should be estimated first; if the estimated revenues will meet these expenditures no great difficulty need be experienced, but if such is not the case, some adjustment is necessary. The estimates and adjustments must be honest, for a fictitiously balanced budget is as bad as none at all. An honestly balanced budget is a plan promoting efficient operation. To reduce estimated expenditures to a point below that at which they can actually be kept, or to estimate revenues above what they will actually realize, is dishonest in itself and obviates any value in the preparation of the budget.

Peculiar situations have arisen in an attempt to comply with the law in Illinois and still prepare a balanced budget. More than once the following case has been found. A budget and an appropriation ordinance were required. The appropriation ordinance should contain the same amounts as the estimated expenditure section of the budget. The appropriation ordinance expresses a limit above which expenditures may not legally be made. In an attempt to show a balanced budget, the amounts have sometimes been entirely different. Estimated expenditures nicely balanced with the esti-

mated revenues have been shown in the budget, and an entirely different set of figures shown in the appropriation ordinance. For obvious reasons, these latter figures have been greater in amount than those in the budget. Any local governmental unit which starts its fiscal year with a lie of this sort certainly cannot be pointing toward efficient operation during the year. Honesty and sincerity in the preparation of the budget and a desire and determination to live up to this budget are absolute necessities. A budget properly prepared paves the way for intelligent, efficient operation throughout the next year. It should not be prepared and then filed. It should be used as regularly as the contractor uses the plan given him by the architect. Any material deviation, unless properly accounted for, may bring financial embarrassment and may indicate inefficient operation. All this does not mean that the budget is a plan which may not be changed. Unforeseen conditions may make a change in the budget wise. The original preparation of the budget should be honest; any subsequent necessary change should be equally as sincere. Both must be based on past experience, future expectations, and good judgment.

The second element in proper control of governmental financing is accounting. Accounting records the actual transactions and compares them with the budget. It is not the purpose of this article to discuss governmental accounting, since such a subject could be quite technical and involved and the basis of a volume in itself. To have proper accounting, persons familiar not only with general accounting principles but also with the characteristics peculiar to governmental accounting should be in charge. The accounts should be maintained in such a way that an accurate financial history is recorded, a constant comparison with the budget is maintained, adequate control is obtained, and understandable reports are easily prepared. Many principles must be observed to do all these things well.

To record an accurate financial history, the accounting records must be devised to meet the individual problem. A general ledger segregated into funds is the heart of the system. Books of original entry, proper auxiliary records, and convenient forms for original recording of transactions are necessary. Each detail of daily transactions should be recorded and finally summarized in the general ledger. The system should be so prepared that a general summarization, as well as any desired detail, is available to anyone to whom such information is of value in his official capacity. Throughout the system, the segregation of records and accounts into fund classifications should be maintained. This is a characteristic somewhat peculiar to governmental accounting and is necessary to avoid confusion of amounts available for various purposes according to law. Such confusion might not only be illegal, but might easily result in unintentional dishonesty.

The accounting system should tie up with the budget and constant comparison should be made. This

can be accomplished more efficiently by including the budget figures in the accounts, showing totals in the general ledger and details in subsidiary ledgers. Such a procedure is entirely workable. It has been tried in practice and has the expected advantage. Whenever all postings are complete, a direct comparison of budget figures with actual figures to date is available so that the budget becomes an active agency and not a useless form. It is a daily guide and not a forgotten sign-post. This constant comparison makes any necessary change in procedure or policy possible before it is too late. No budget is as valuable as it might be, unless this constant comparison with the actual figures shown in the accounting system is made.

Control is one of the most important features of any governmental accounting system. This control is most important in relation to expenditures. It must be regularly determined whether the actual expenditures are in accordance with those estimated in the budget and made a part of the appropriation ordinance. A feature in this control which has not been mentioned before emerges here. Not only must the actual expenditures to date be observed, but an accurate record of commitments must be incorporated. If this were not done a governmental unit might find itself in exceedingly embarrassing financial situations, particularly near the ends of fiscal periods. By both totals and details, encumbrances should be recorded carefully. When this is done, the total of actual expenditures and encumbrances may be compared with the estimated expenditures to determine what amount is free for further commitment or expenditure at any time. This comparison should be made by individual appropriations as well as by totals. The keeping of such comparisons in the records will prevent the unintentional making of expenditures too great to allow for previous commitments. Such control promotes efficiency and care in the management of the finances of any governmental unit.

The accounting records should be so maintained that reports may be readily and easily prepared. Not much need be said about this now, since reporting will be discussed as one of the elements of financial management a little later. Let it be sufficient to say here that the accounting records should be so kept that understandable reports may be prepared from them.

The third feature of a properly administered financial system is the audit. Auditing in general may be internal or external. The internal auditing features of any system are important, and every system should be so devised that there are regular checks within the system itself. This may be contrived in several ways. Different individuals may be keeping records which automatically check the records of others. In a large enough unit, an auditor may be a regular official of that unit and this auditor may be checking the records regularly. Regardless of how extensive this system of internal audit may be, an audit should be conducted at least once each year

by some external agency. The methods employed are various. In some cases the state government performs the annual audit. In some cases, either the state or an independent auditor does the work. In some cases, only independent auditors are employed. In many other cases no audit of any sort is conducted. The value of audits conducted by state agencies varies considerably. Sometimes it is a routine and perfunctory procedure which accomplishes little. At other times it is an audit performed by persons entirely capable and with results that cannot be questioned as to their benefit.

"Outside auditors are frequently employed to make independent governmental audits. The independent audit is a fundamental accompaniment of a well-conducted private business. Such an audit is no less essential to the efficient management of the public business."

When a governmental unit has the initiative to request an audit by an independent auditor, there are still certain disadvantages that must be guarded against. In the first place, many private audits are awarded to the lowest competent bidder. When personal professional services are involved, such a system is malicious. Many competent accountants will not offer their services under such circumstances. Other evils of the bidding system for audits need not be mentioned, but the sooner contracts for such services are made on a basis of selection in some other manner, the sooner will such services become more desirable and efficient. Cases have been noted in which audits under the bidding system have been awarded at prices utterly ridiculous when compared with private business audits of similar nature. Reasonable observation shows that the auditor is either losing money on the job, or he is not performing a complete audit. It is not very difficult to find the correct answer.

Fundamental principles of accounting are the same for any type of business, but there are some characteristics of governmental accounting which make it quite different in some respects from accounting for commercial and industrial organizations. When only general principles are applied in the audit of a governmental unit, the results cannot be the best. A governmental unit engaging an auditor should be sure that the accountant understands these peculiar characteristics of governmental accounting. The absence of the profit and loss element, the absence of capital, the division into funds, and the inclusion of the budget in the accounts make this feature important. Systems have been noted, which have been installed by accountants not having such training, in which all of these points have been disregarded. Here is a responsibility upon the accounting profession as great as upon the governmental officials and the citizen. The accountant must acquaint himself with these features and so be ready to perform his part in advancing governmental efficiency. Recent certified public accountants' examinations show that this problem is being recognized by the profession.

In any audit, it should be remembered that the auditor is not just a checker of entries and arithmetic, but that he is an adviser and critic. Under his guidance a system should undergo continued betterment.

The last of the four elements in a proper governmental system is adequate reporting. Reports may be of many different types. They may be made to administrative officials or to the public. Some will show many details; some will be summarizations. Reports are often the only way in which some citizens may learn what is being done by a particular governmental unit. Any accounting system should be so set up that these reports may be easily prepared, and so that they may be available soon after the period which they cover. Reports issued too late are useless. They must be readable and understandable. From the layman's point of view, the report is exceedingly important. In most cases it is the only way in which he may know what his government is doing and how efficiently it is operating. Each citizen should demand adequate reports, study them, and take an active interest in his government. In no other way may distinct improvement be expected. The contact between the citizen and the entire financial system including budget, accounting system, and audit, is through the report. This contact is good or bad as the report is good or bad.

In Illinois there are 15,118 taxing units. These are made up of state, counties, townships, road districts, cities, villages, incorporated towns, elementary school districts, twelve-grade school districts, high and non-high school districts, park districts, sanitary districts, fire protection districts, forest preserve districts, mosquito abatement districts, public health districts, and a tuberculosis sanitarium district. Every resident of the state lives within at least four of these districts, and some live within as many as ten or twelve such districts. Such overlapping of districts in this state suggests that many of them should be abolished and their duties absorbed if necessary by other existing units. With financial control thus centralized, the interest and knowledge of the citizen could be greatly increased, with some saving in actual cost.

A brief summary of the financial control in the most important taxing units in Illinois will now follow. In cities, villages, and incorporated towns, there is comparatively little compliance with the law requiring the preparation of budgets. "Entirely aside from the question of administrative efficiency, every governmental unit should adopt a budget and preserve sound financial practices, because it handles other people's money." Accounting systems are inadequate in general, many small cities having no more than a cash book and a warrant register. Many municipalities proceed for many years without audit, either internal or external. The reports vary from single sheets to bound books. In the entire group there is little uniformity. Inadequacy appears in every division.

Illinois has 102 counties, of which 73 state that they prepare budgets.

Accounting procedures in the counties are indifferent. There is no standardization, and many are inadequate. All counties must have an audit, by either an elected or an employed auditor, depending upon the size of the county. Many of these audits are awarded on the basis of bids. Reports required and published are difficult to analyze on account of the great detail included.

There are 12,121 school districts in Illinois, all of which must prepare budgets. There have been many objections to the budget law as it applies to school districts. Greater uniformity in the accounting records is found for school districts than in any other form of local governmental unit. Furthermore, a more extensive system of audits is found than in any other of the local units. Numerous reports must also be filed by the school districts.

Illinois has 1,435 townships and 181 road districts. Inadequacy here is great. Budgets should be prepared but seldom are. Records are almost non-existent, audits almost unheard-of, and reports meager.

The apparent lack and inadequacy of budgets, records, audits, and reports in local governmental units is deplorable. There should be some consolidation of units, followed by improvement of the financial systems in all of them.

In conclusion, let it be said, as in the beginning, that each of us has an interest in this business of government. We not only have a right to a proper financial system in each, but we have a duty to see that such financial systems are put into effect. Nothing will happen if we let the others do it. We must take an active interest ourselves. Each one of us should see to it that every taxing unit with which we are concerned has a properly balanced budget, an adequate accounting system, a competent independent audit, and enlightening public reports.

MORE DETAILED STUDY

Allen, H. K., *Control of Expenditures in the Local Governmental Units of Illinois,* Bureau of Business Research, Bulletin No. 61, 1940.

Quotations in the article are taken from this study.

Corporate Capitalization and the Economic Cycle

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Some students of corporation finance believe that since 1933 there has been a singular lack of progressive literature on the subject. New textbooks and revisions of old textbooks in the field have appeared, but recent scientific contributions to this branch of knowledge have been meager. It is true that the general literature on social control of corporations has been fairly abundant in the past eight years. But this material has dealt primarily with criticism of, and attack upon, the corporate system. It has been concerned largely with seeming evils in our economic and social structure which allegedly are attributable to the modern system of corporations. Probably a need for increased regulation of corporations is a natural complement of a maturing national economy. That attention of students of social problems should have been directed in recent years toward a more rigorous policing of the economic system is logical; that appeal for reform of the corporate system should be most urgent in periods of economic stress is in accordance with human nature.

Nevertheless, it is an oversight to infer that private corporations have not had particular financial problems of their own—problems especially incident to the gyrations of the economic cycle. The swings of the cyclical pendulum have not only magnified *for society* the problem of the corporation but have also magnified *for the corporation* the problem of private finance. In brief, the severe economic maladjustments of the past decade have caused much attention to be given to the problem of social control of the corporation; perhaps a somewhat neglected phase of these same maladjustments has been the problem of corporate financing resulting from them.

The corporate form of business enterprise is firmly entrenched in the American economic system. As time moves on, it affects the welfare of more and more citizens, as security holders in corporations, as employees of corporations, as customers of corporations, or even as vendors to corporations. Extension of interests in the corporation has been of unprecedented magnitude in the past half century. In view of these manifold interests it naturally follows that the success or failure of corporate enterprise must have its counterpart in human welfare. Corporate success or failure is measured in financial terms and depends largely on financial policy. The financial fortune of corporations, with its inevitable bearing on human

welfare, thus becomes a timely and logical subject for inquiry.

Corporate financial problems related to the economic cycle might be divided into four groups: (1) problems of total asset investment or of capital requirements; (2) problems of capitalization, the term "capitalization" being employed here to indicate all securities, stocks and bonds, outstanding; (3) problems of working capital, that is, of short-term liquid assets; (4) problems of income administration, particularly dividend policy. This article will deal only with the first two groups of problems, those centering about capital requirements and capitalization.

Contrary perhaps to the seeming complexities of corporate financial administration, sound principles of corporation finance are fundamentally simple. In fact, it is violation of the most elementary principles of borrowing which time after time has carried prominent corporations into receivership. Perhaps it is only natural that the foundation of financial error is apt to be laid in prosperity. Business failures are, of course, most numerous in periods of crisis and depression; yet the defaults which precipitate receivership in periods of financial stress are often the mere outward manifestations of managerial errors committed in boom times. To guard against personal illness it is elementary that one in a state of good health should avoid unnecessary risk of impairment of that health. To guard against corporate failure it is equally elementary that a company in sound financial position should avoid unnecessary risk of impairing that position. However, like some individuals, many corporations, for the sake of immediate benefits, have exhibited a disregard of the future, however inevitable that future may be.

The lure of immediate high profits is apt to create the initial problem of asset or capital requirements in years of prosperity. In this period market prices of commodities tend to rise, often more rapidly than production costs, thereby increasing the profit margin of selling price above cost. The rapid increase of profits causes business firms to seek more capital, primarily for operating purposes, and also initiates rising prices for corporation stocks. The favorable market prices for stocks in turn facilitate the acquisition of new corporate capital by the sale of new shares in the securities market. Corporate expansion is thus rendered easy in a period of general prosperity.

But while the prospect of high profits may invite both a corporate demand for more operating capital and a favorable stock market in which to obtain such capital, in the lure of these profits are the seeds of economic disequilibrium. Excessively high earnings do not remain forever; orthodox economic theory has declared for years the impermanency of pure profits, or earnings in excess of a reasonable return for the use of land, labor, capital, and management. Yet, the general tendency in prosperity is to *project* immediate high earnings into the future, not at existing rates of return but at ever-increasing rates

of return; that is, temporary actual high profits are not the sole basis of estimating the future, but upward *trends* are made the excuse for present commitments based on the anticipation of future earnings substantially above the already high levels of the present. Probably the most fundamental error in the purchase and sale of corporate securities in the 1926-1929 period was the pricing of stocks according to projected trends of earnings and the neglect of actual, average earnings and basic asset values. Overlooked was the simple yet primary principle that the very upward movement in the level of earnings would set in motion the forces to cause a decline. But the human tendency in prosperity periods is to overshoot the mark; and in this respect corporations have been human.

In the first place, corporate enterprises tend to overestimate their needs for operating capital in prosperous years. In anticipation of higher earnings than they have ever achieved, they build plants, often at high costs, and load up on inventories, often at high price levels, to accommodate a market magnified by over-optimistic assumption. Perhaps in a few months—perhaps in a year—the extended plant and equipment become idle, yielding no income, while certain depreciation and other fixed charges continue in spite of this idleness. In the same brief period the expanded inventory becomes over-stocked, marketable only by drastic reductions in price.

In the second place, corporations plunge readily into overexpansion of assets in prosperity because of the comparatively easy sources of capital. Corporations obtain expansion capital from four principal sources, (1) retention in the company of its own earnings; (2) sale of common stocks; (3) sale of bonds, long-term notes, and preferred stocks; (4) short-term borrowing, often by bank loans, for maturity periods of less than one year. Each of these four sources of corporate capital is likely to be an easy one in periods of prosperity. Company earnings tend to be high in such periods, thereby facilitating expansion by retention of earnings. Common stocks sell at peak levels in prosperous years, expediting enlargement by this method. While bonds, long-term notes, and preferred stocks do not sell at the very favorable prices that common shares command, long-term *borrowing* is fairly easy in a boom period. The years 1926-1929 offer abundant evidence of the liberal extension of bank and other short-term credit for business operations.

The formation of holding companies—corporations which hold as assets the securities of other companies, primarily for control purposes—is one phase of the scramble for corporate capital in prosperous years. The holding company tends to spring up in periods of inflation and general prosperity. For its own income it usually must rely largely on the residual stock earnings of the subsidiary companies in which it holds shares. And to finance partially the purchase of these controlling subsidiary shares, the holding company in the past has issued collateral trust and debenture bonds

and has borrowed on short-term loans. Against securities with *variable* earnings and consequently *variable* values — stocks — the holding company has issued obligations with *fixed* principal maturities and *fixed* interest charges. The rise and fall of the Insull public utility holding-company empire is a lasting monument to the hazards of this process. When the subsidiary companies failed to earn according to the over-optimistic estimates of holding company promoters, they could pay little or no dividends on their stocks, in consequence of which the latter declined in market price. Since these stocks were the principal assets and source of income for the holding company, the reduction of dividends on them, and the consequent decline in their market price, left the holding company imperiled—often helpless—in meeting the fixed charges and principal of its own obligations. The earnings and asset values of the holding company shrank or disappeared, while the fixed debt (the cold realities, in the words of Mr. Roosevelt) remained, with receivership often unavoidable.

In the writer's opinion, no formula exists to serve as a guard against overexpansion. Yet, some companies, perhaps by exception, have avoided or minimized it. At least, a prudent corporate management should be alert to three trends, no two of which are necessarily the same and any of which may be confused with the others. In the first place, *the cyclical trend* relates to general improvement or decline of business and industry on a wide front. In the second place, *the industrial trend* relates to an improvement or decline common to a particular field of business activity. In the third place, *a trend pertinent to a particular company* reflects improvement or decline in its own activity and competitive status. Occasionally, all three of these trends move together. Certain automobile companies experienced upward trends while the industry itself expanded in a generally expanding phase of the economic cycle in 1925-1929. A few automobile companies, well-known ten to fifteen years ago, faded out in the midst of prosperity in their industry and in the general economy. In spite of a general prosperity in the late twenties, the traction industry was in a state of decline. Yet, even in the 1930-1934 period, and in spite of weakness in the industry in general, a certain traction line in the Middle West, by elimination of some competitive bus traffic, was able to improve its earnings position.

The existence of these trends suggests some danger in the principle of following the crowd. Probably the trend of fundamental significance to any one corporate management is that of its own enterprise. The general industrial and cyclical trends are important as aids in planning the future, in budgeting costs and revenue; the cyclical trend is especially important in respect to rates of interest on borrowed capital. But great danger inheres in the too prevalent tendency to expand on the basis of just one phase—the prosperity phase—of the economic cycle.

The big temptation in prosperity is the prospect of profit on operat-

ing capital. Consequently, corporate management is apt to overextend the operating capital—that is, plant and inventory—to reap the excess earnings of a boom period. Whatever the source of the corporate assets—whether the assets are obtained by retained earnings, borrowing, or sale of common stock—a grave tendency to overinvest in physical property persists. Retained earnings of prosperous periods, for instance, have been found to seep toward the fixed property accounts. Once sunk in plant, those earnings tend to be sunk permanently. And it is this excess commitment of funds to operating capital which causes subsequent trouble as plants become idle and inventories frozen.

Alert management will endeavor to avoid crystallizing the company funds in physical properties to the extent that such properties have only a temporary earning power. Prudent management will consider the liquidity of the enterprise, as well as the peak market for commodities, in a boom period. Recognition should be given to the temporary nature of the market at this time; foresight in the prosperity period would reveal an impending scramble for cash and other liquid capital that will supplant the scramble for operating capital. And if the crisis and liquidation period ensuing prosperity brings anything, it brings a scurrying for cash and other liquid assets. Cash can be converted into plant in a prosperous period much more easily than plant can be converted back to cash in depression. The erection of twenty-year plants to serve a one-year market usually involves a strain—often a serious one—on the company's cash assets. Probably some temporary profit would be lost if operating capital were not extended to accommodate peak demands; but it seems entirely logical to sacrifice a part of the temporary peak income of years like 1928 and 1929 if thereby heavier and disproportionate losses through idle frozen capital can be avoided for years like 1932 and 1933.

Practice shows corporations expanding in prosperous and inflationary periods when high costs generally prevail. Yet, the logic runs counter to the practice here. It seems sound that a company should aim to expand in the period of low and dull activity—usually in late depression—when low costs generally prevail. This theory assumes sound managerial timing and foresight. It assumes the courage to break with the herd of a stampeding bull market before that herd leaps over the precipice.

But unbalance in the assets of corporations in prosperity often has its counterpart in unbalance in the *sources* of those assets. This consideration leads logically to the second group of corporate financial problems related to the economic cycle, problems of capitalization or security issues. Overexpansion is accomplished often by overborrowing. Unfortunately, the open market offers encouragement, rather than resistance, to expansion programs in the period when *overexpansion* is a grave peril. As previously indicated, financing by either stocks or bonds is comparatively simple in the prosperity optimism, and herein rest both

a great opportunity and a great danger for financial management.

Since in a boom period the market offers unusual facility for almost any type of security issue, companies burdened by overbonding may then have an excellent opportunity to sell stocks and apply the proceeds of the stock sales to retirement of their bonded debts. By this means a company may supplant bonded debt, with its fixed interest charges and principal maturities, with common or preferred stock without fixed claim to earnings or principal. Most recent bond issues are callable at the company's option, and if the bonds have not been made callable when originally issued, a company can often buy up its bonds in the market. The prosperity tendency of bond prices to sag in relation to stock prices would expedite this process. It is the default on *fixed*-claim obligations — often bonds — which brings corporate failure and receivership. Corporations do not go into receivership because of failure to pay dividends or principal of stocks. For years the overbonding of certain American railroads has been a major obstacle in their financing and a highly significant factor in the many railroad receiverships in our history. In the writer's opinion, some of the railroads neglected clever strategy when in the 1926-1929 period they did not sell stocks and apply the proceeds to the redemption of that part of their bonded debt which was excessive in relation to their average earnings and asset values.

Of course, this recapitalization will not eliminate overexpansion. It merely increases stock as a means to reduce fixed debt. It will not adjust the company's asset or property investment. Yet, to the extent that overbonding is present, whether or not the company is also overexpanded, this program would tend to eliminate overbonding and allow the company to enter less profitable periods of the economic cycle without the overhanging burden of excessive long-term fixed claims against its earnings and assets.

Similarly, a company may have special opportunity to reduce heavy bank loans and other short-term debt in prosperous years. Like bonded debt, bank loans are a potential cause of receivership. The corporation which moves out of prosperity and into crisis with a heavy current debt is a likely candidate for insolvency, especially if the company has difficulty in converting its inventory into cash. *The unavoidable conclusion seems to be that a sound capitalization is most readily attainable in prosperity, and the capitalization effected in prosperity should be one that will avoid trouble in depression.*

However, it is a fact that many corporations do not follow sound capitalization theory in their prosperity practice. They take the profit intoxication of boom years as the occasion for incurring more debt rather than retiring debt. Thereby, they may invite financial ruin; yet some expedients may be suggested to stave off that ruin. And these expedients, fortunately, may be applied even in depression years. Of course, if a company has borrowed very excessively and there is no

reasonable hope that the enterprise can ever be returned to a normal earning basis, the only outlet is receivership and liquidation. If the company is definitely overbonded, yet has a reasonable chance to survive depression and return to a sound earnings position, some financial remedies may be of major aid.

The depression period—particularly in its final stages—is apt to bring marked reduction in the general market rate of interest, as the supply of liquid capital becomes heavy in relation to the demand for it. At this stage in depression, borrowing corporations are apt to be confronted with a strong bond market and a weak stock market. Bond market prices have been particularly high since 1934, reflecting the low interest rates prevalent in that period and the preference of security buyers for senior, protected claims rather than proprietary, residual claim stocks. Stock prices in this period have been comparatively low, reflecting low corporate earnings, present and prospective. Now, when market interest rates fall, old bonds formerly marketed at par tend to sell at premiums above par and new bonds can be marketed at par with lower interest rates. A perpetual 5% bond sold at par of $1,000 would tend to sell for $1,250 if the market interest rate on that type of security dropped to 4%. The $1,250 price would simply reflect the valuation of the fixed $50 of interest income at the new market interest rate of 4%. The low interest rates since 1934 have been the signal for many refunding operations, operations in which corporations retired old bonds from the proceeds of new issues at the lower interest rates, thereby reducing borrowing cost and to that extent increasing stock earnings.

Confronted with an unfavorable stock market and a favorable bond market, corporations would not be in good position to sell stocks and apply the proceeds to debt retirement. Such procedure might be ideal from the standpoint of eliminating fixed debt and financial risk; in depression years, however, low prices of stocks are apt to render this program inadvisable. Sufficient stock sales to accomplish the desired redemption would involve such dilution of old stock equities, obtained at much higher price levels, as to negate such a proposal.

Granted that the immediate accomplishment of the ideal capitalization is impossible, the next best course might be to effect it over a period of time. This course presents a worthy alternative. And it often can be accomplished with a minimum of expense to the company through the expedient of convertible bonds, bonds which at the holder's option can be exchanged for stocks. These convertibles would be sold to supplant older issues carrying higher interest rates. Granted that corporate earnings do improve and thus carry upward the price of the company's stock, convertible-bond holders may be expected to exchange their bonds for stocks, as the latter offer dividends substantially higher than the interest paid on the bonds. The real effect of the convertible bond, so employed, is that of a deferred stock sale. By this process the corporation accomplishes over a

period of time, perhaps over several years of recovery, what it could not have accomplished in depression—the retirement of debt through the issuance of stock.

The use of stock purchase warrants attached to bonds, giving bond holders the right to *supplement* their bond holdings by the purchase of the company's stock, may serve the same purpose of debt retirement when the company applies to bond redemption the cash received from the sale of the stock. Here again immediate extinction of debt is unlikely. But granted that a revival of earnings may make the company's stock attractive, enough warrants might be exercised to provide cash for an appreciable redemption of the bonds.

One other debt-retirement expedient merits attention for use in the late depression period. Obligatory sinking-fund covenants — promises to accumulate cash funds for total or partial redemption—may be included with bond issues. The sinking-fund accumulations are usually spread over the life of the bonds. The presence of an obligatory sinking-fund covenant may serve as a credit tonic and so facilitate the sale of the bonds at lower interest rates. Granted that a company can earn 5 or 6% on its borrowed capital and, by virtue of the sinking fund and a favorable late depression bond market, can market its bonds at par at interest of 3½%, an appreciable saving can be effected by retiring older issues with 5 and 6% interest, by the new and low-interest sinking-fund bonds. In some cases the saving in interest of itself would so increase net earnings as to provide thereby the proceeds for an appreciable reduction of debt.

One caution concerning obligatory sinking funds is in order, however. Default on them may be the cause for failure and receivership. If the future prospects particularly favor the accumulation of the retirement fund, the method probably is feasible. The baseball runner who attempts to "steal home" looks great if he is "safe"—he looks poor if he does not "make the plate." Similarly with the obligatory sinking fund—it looks like good financing if it works; it looks like receivership if it does not.

Perhaps the question may arise: Is all this practical in business or is it mere academic fancy? In answer, one may simply suggest an examination of the facts. It was not academic fancy that the U. S. Steel Corporation announced in the spring of 1929—certainly a boom period—a program of debt retirement. In the spring of 1934 the New York Central Railroad issued almost $60,000,000 of convertible, secured bonds; by June, 1937, over $58,000,000 of that issue had been converted, according to *Moody's Manual of Investments*. In the spring of 1936 the Youngstown Sheet and Tube Company refunded approximately $90,000,000 of old bonds by two new issues at lower interest rates. The company issued $60,000,000 of first mortgage sinking-fund bonds and $30,000,000 of convertible debenture bonds. The sinking-fund bonds sold at 98½, interest rate 4%; the convertible debentures sold at 102½, interest

rate 3½%. In three of the six years prior to this financing, the Youngstown Company had incurred operating losses, and its earnings for ten years had been very irregular. The facts in this case reveal two conditions of importance: first, the company was apparently overbonded; second, the company did take advantage of the favorable bond market, but with a view toward debt retirement over a period of years. This financing occurred in the spring of 1936; by September, 1937, according to Moody's reports, $29,688,000 of the original $30,000,000 of convertible debenture bonds had been converted into stock. This is not academic fancy; it is theory based on fact.

Yet the cynic may ask: Doesn't all this assume capable and honest corporate management out of line with reality? In the first place, may it be pointed out that corporations do not provide the only examples of mismanagement through the economic cycle? It is true that many—perhaps most — corporations overexpanded or overborrowed—or did both—in the 1926-1929 period. But in doing so they simply paralleled in principle the overproduction and overborrowing of American farmers in the War and post-War periods, when foresight and wisdom would have favored contraction of debt and curtailment of output. *Temporarily* high agricultural prices lured the farmer into excessive production and excessive debt, just as *temporarily* high profits lured corporate management into error. In principle these corporate errors were paralleled also in the overconstruction, largely on borrowed funds, of dwellings and other real estate projects. A further parallel is evident in the enormous increase in the use of installment debt to finance consumer's goods, especially automobiles, in the boom period. Individuals who rushed headlong into the stock market, tempted by temporary prospects for higher profits and prices, made excessive commitments in shares, often on margin, the essence of which is purchase on borrowed funds. And even some professors of economics cannot claim to have been immune to the speculative contagion which engulfed those who should have known better. Speculators, individual consumers, real estate contractors, farmers, and corporations—not corporations alone—have been guilty of mismanagement.

In this respect, the "reformers" may have been top-heavy with criticism of the corporate system, probably of the general economic system. It is not at all the writer's idea that the corporate system and the economic system do not need modification. Modification of our institutions is essential to the progressive and dynamic world in which we live. But not *all* the fault is in our social institutions. Much of it is private and individual in nature. We need to look in the mirror. The riding may be rough not because of the condition of the highway, but because we have neglected proper lubrication, or have overinflated the tires, or actually have a flat tire.

The drift of this doctrine is that improvement, private and social, does not depend entirely on modification of our corporate or our social

order. Our financial and economic distress has not been wholly the fault of any system. Much of our difficulty centers about the behavior of individuals and private enterprises in relation to the system. No order—financial or social—is apt to be successful without private integrity and intelligence.

The final conclusion offers no substitute for sound and honest private management. Qualified corporate management would seek to avoid the excesses in expansion and borrowing that are invited by temporary profits. In keeping with a long-term viewpoint, more extension would take place in depression periods, when construction, materials, and financing costs are more favorable. If all corporations employed this plan, it might be contended, the advantages of expansion in late depression would disappear as heavier demand for capital in that period elevated price levels. Similarly, the disadvantages of expansion in prosperous years would tend to disappear as lower demand for capital checked rising prices. The consequent situation is the particular one society is seeking. It would mean leveling off the peak of prosperity and filling in the low of depression—the net result would be greater stability, a goal which society generally favors.

The financial policy advanced here is thus in the interest of society; socially, as well as privately, it seeks a minimum of maladjustment in production and prices. This theory *does* assume competent and honest private management, but private competence and honesty are *fundamental* to progress in *any economy*.

Background, History, and Constitutionality of the Federal Income Tax

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Although to those of us living in the United States the income tax may appear as a recent form of taxation, it has been in use, in some form or other, for several centuries. A tax of this kind was used by the Italian cities in the Middle Ages and, as early as 1451, was substituted for property taxes in Florence.

The income tax has a part in the more modern systems of most of the important countries of Europe. Austria began to use such a tax in 1702; England, in 1799; Prussia, in 1811; Italy, in 1864; France, in 1871; Nor-

way, in 1882; Holland, in 1892; Sweden, in 1897; Japan, in 1899; and Denmark, in 1903.

In the United States, state income taxes have been in existence longer than the Federal income tax. In 1634, the Massachusetts Colony used a tax which might be considered an income tax; shortly thereafter, several other colonies followed the example of Massachusetts Colony. These taxes did not greatly resemble modern income tax systems, but they were based on the standard of ability to pay as measured by employment.

In 1864, Pennsylvania, in 1870, Virginia, and in 1871, Tennessee tried income taxes in their fiscal systems. In 1910, the first really serious attempt to tax corporations under a state income tax statute was made by Wisconsin. In the following two decades, the lead of Wisconsin was followed by Arkansas, California, Connecticut, Georgia, Massachusetts, Mississippi, Missouri, Montana, New York, North Carolina, North Dakota, Oregon, South Carolina, Tennessee, and Virginia. By 1936, thirty-one states had such laws. In the majority of cases, net income is used as the base for state income tax purposes. Net income is measured by the remainder left after business expenses and certain non-taxable income items are deducted from gross income.

It is extremely important that our Federal law be sound, not only for Federal taxation but also for state taxation purposes, because state legislators apparently have tried to copy the Federal Income Tax Act in forming state statutes. Some of the state laws are patterned very closely after the Federal law, except that certain items are excluded if they are not considered proper objects of taxation within the limits set by the state constitution.

The Federal government had not tried an income tax prior to the passage of the act of 1861. It is true that in 1815, Secretary of the Treasury Dallas suggested that such a tax be used to finance the War of 1812, but no action was taken, since the war soon came to an end.

During the Civil War period, both the United States government and the Confederate government resorted to the use of income taxes. The first Federal act was passed in 1861 but was not put into force, because it was felt that administration of the act would be too difficult and that the revenue obtained would not be sufficient for the needs of the period. Although the act was worded ambiguously, it seems quite clear that net income was the base intended for taxation. Most of the details of administration and the determination of income were delegated to the Secretary of the Treasury.

Additional acts were passed in 1862, 1864, and 1867; and in 1869, the law was extended to 1871. From 1872 to 1894, there were no Federal income tax statutes. Discontinuance of the Federal acts in 1872 can be attributed to several factors. The many weaknesses of the laws of 1861 to 1871 and of their administration were an important force in their being discarded. After the patriotic fervor of wartime had subsided and the decreased need for

revenue was satisfied by the retention of a protective tariff, it was decided that less onerous forms of taxation than an income tax could be used. At that time, taxpayers were totally unused to income taxes and considered them an unwarranted invasion of personal affairs.

The Civil War acts were not at first challenged, but, in the late 1860's, their constitutionality was questioned, principally on the grounds that an income tax was a direct tax not levied in proportion to the census, as required by Article 1, Section 2, Clause 3 and Article 1, Section 9, Clause 4 of the Constitution. In several cases, decided from 1868 to 1881, it was held that the Federal income tax was not a direct tax and that the direct tax clause in the Constitution referred only to capitation, land, personal property, and similar taxes.

Since the Civil War acts were allowed to lapse in 1872, the question of constitutionality did not again arise until an attempt was made to revive the Federal income tax in the early 1890's. When more revenue was needed in 1893, an income tax was immediately suggested as a good form of taxation. President Cleveland, in his message to Congress in December of 1893, proposed that a tax be placed on the incomes of corporations. Several income tax bills were introduced in 1893, but none passed. Finally, on August 28, 1894, an income tax act was approved. In the main, it was a copy of the Civil War acts and levied a tax on "all gains, profits and incomes derived from any kind of property, rents, interest, dividends, or salaries, or from any profession, trade, employment, or vocation."

This act was passed with little discussion and was so poorly drawn and full of contradictions that even the advocates of an income tax were probably not very much disappointed when it was declared unconstitutional in 1895 and was not put into operation. The decision by the Supreme Court in *Pollock v. Farmers Loan and Trust Co.* (157 U. S. 429, 158 U. S. 601) was a direct reversal of several of its earlier decisions and was made by the close vote of five to four, whereas in earlier cases the Court had unanimously held such a tax constitutional. The decision in the Pollock case was to the effect that since taxes on realty or personal property are direct taxes, taxes on the income therefrom are also direct taxes. The fact that this case was a closely contested reversal of several previous decisions has made it somewhat unconvincing.

There is no hard and fast rule as to the nature of a direct tax. Whether a tax is direct or not is determined by time, country, and surrounding circumstances. Whether or not the Federal income tax is a direct tax under the Constitution is difficult to determine, because no such tax was in existence when the Constitution was framed.

In spite of the fact that an income tax was considered unlawful at the time, the tax of 1909 on corporation incomes was passed. In order to avoid the Supreme Court

ruling, this act was disguised as an excise tax on the privilege of doing business.

The members of some of the most important public accounting firms in this country sent a joint letter to members of Congress regarding their objections to the 1909 act. These accountants felt that the language of the act was not in accord with the methods then in use for computing income. Their distaste for the law was caused by provisions which required the use of "expenses actually paid," "losses actually sustained," and "interest actually paid" in determining taxable income. They advocated deductions for: expenses incurred, whether or not paid; losses actually ascertained and written off, whenever incurred; interest accrued, whether or not paid; reasonable allowance for depreciation; and taxes accrued. In short, they wished the law to prescribe an accrual basis and not a cash basis of accounting for income.

Attorney General George Wickersham in his reply to the joint letter of the accountants stated that the bill was purposely framed on a cash receipts and disbursements basis. Luckily for the peace of mind of the accountants, the Commissioner of Internal Revenue disregarded many peculiarities of the law itself and tried to interpret it in the light of general standards on which corporation accounts were being based at that time.

The uncertainty as to whether the 1909 act was constitutional or not and the undesirable provisions it contained gave impetus to a movement for amendment of the Constitution to permit income taxes to be levied without regard to apportionment according to the census. This movement culminated in the passage by the Senate on July 5, 1909 of a bill for a constitutional amendment. The Sixteenth Amendment and the 1913 act (which went into effect on March 1, 1913) resulted shortly thereafter.

The Sixteenth Amendment provides that:

"The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration."

The 1913 act was much like that of 1909, and, in spite of the Sixteenth Amendment, the constitutionality of the 1913 act was still questioned, on the grounds that it had been made retroactive to March, 1913, that it used progressive rates, and that it violated the "due process" clause of the Constitution by using collection of tax at the source. In *Brushaber v. Union Pacific Railroad* (240 U.S. 1, 1916), the Supreme Court decided that the act was constitutional.

The matter of constitutionality has received much attention—perhaps more than it deserves—in discussions of Federal income tax statutes. The usual arguments are that taxation of income according to our present system is permitted only under the Sixteenth Amendment and that, therefore, Congress may tax as income only that which the legislators and the public conceived to be income when that amendment was ratified.

This position is weak, for several reasons. There is some doubt whether or not amendment was necessary. At most, the Pollock case held that a tax on income is direct if that income is derived from sources upon which direct taxes are levied. Whether or not this ruling should be extended to cover a tax on income derived from operating a business is doubtful. Also, it is virtually impossible to determine just what Congress and the people meant by "income" when they sanctioned the Sixteenth Amendment. Finally, even if it is assumed that the Sixteenth Amendment was necessary and even if, under this amendment, we must adhere to the common concept of income held when the amendment was passed, it is not certain that a so-called income tax need be employed to accomplish the purpose of levying a tax based upon income.

The act of 1909 was drawn up in the form of an excise tax on the privilege of doing business, and it was declared constitutional in *Flint v. Stone Tracy Co.* (220 U.S. 107, 1911). A similarly disguised tax could now be devised to circumvent the Sixteenth Amendment. No reference need be made to the latter; the tax need not even be called an income tax; it could be a license tax, the amount to be measured by a legal concept—statutory income. Apparently the Constitution controls only the form and not the substance of an action.

Such an excise tax might be limited in scope by Article 1, Section 8, Clause 1 of the Constitution, which requires that all duties, imposts, and excises shall be uniform throughout the United States; but it would avoid both the general requirement of apportionment according to the census and the necessity for conforming with changing interpretations of the concept of income inherent in the Sixteenth Amendment.

Additional important income tax acts were passed at frequent intervals between 1916 and 1940. They follow the same general pattern as that passed in 1913 but have undergone many important revisions of individual portions.

In general, it may be said that although there are many difficulties and complexities connected with the Federal income tax, and complete simplification is not feasible, some clarification and simplification is possible if the many provisions are codified properly and the statute is limited to general propositions and standards for determining taxable income.

The Theory and Practice of Collective Bargaining

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The preamble of the National Labor Relations Act contains the following statement of public policy: "It is hereby declared to be the policy of the United States to eliminate the causes of certain substantial obstructions to the free flow of commerce and to mitigate and eliminate these obstructions when they have occurred by encouraging the practice and procedure of collective bargaining and by protecting the exercise by workers of full freedom of association, self-organization, and designation of representatives of their own choosing, for the purpose of negotiating the terms and conditions of their employment. . . ." If this statement thus represents the present public policy of this country, it indicates a general acceptance of the principles of collective bargaining as being socially desirable. Some inquiry into the nature of the principles and practices of collective bargaining may therefore be worth while.

Personal prejudice or bias should not be allowed to creep in and defeat all attempts at objective analysis and understanding. Perhaps in no field of economics is the subject matter so hard to analyze in a cold, dispassionate, scientific manner, free from all personal opinion, biases, or prejudices, as in the field of labor relations. This difficulty is due, of course, to the fact that as human beings with certain deep-seated instincts, stimuli, and responses which have their origins in both our heredity and our environment, we cannot readily divorce our thinking from our personal feelings, experiences, and observations. And yet in no field of human relations is there greater need for open-minded, objective, clear thinking than in the field of labor relations.

To begin with, then it is well to remember that both employers and employees are human beings, with much the same basic urges, wants, and needs; that they both seek to work out their economic salvation in a price-and-profit economy, which means they both pursue the same selfish objectives of material and economic advancement; and that naturally and obviously these two groups, in pursuing these selfish objectives, come into conflict with each other at various points. The implication is that we must appraise the aims, methods, and objectives of both employers and employees in the light of our present economic system or organization, which places the emphasis upon private profits and accumulation of wealth as a measure of success and as a con-

dition of material prosperity and which relies upon competition among the various groups to regulate and determine the share of the national income each will receive.

Now just what does collective bargaining mean or involve? Collective bargaining refers to the procedure or process by which an employer or employers and a group of employees agree upon the conditions of work. This process may, of course, take any one of a number of forms. For example, it may involve bargaining between a small group of workers and a single employer, or it may involve bargaining between a large group of workers and several employers, or, finally, it may involve bargaining between a national organization of workers and a national organization of employers. Whatever the form it may take, the essential characteristic of collective bargaining is the attempt to reach an agreement upon the terms of employment by group action rather than by individual effort.

There is a rather common opinion that collective bargaining and trade unionism are products of the factory system of production,—that they began with the factory system and spread with it throughout the world. But this view is not exactly correct. Collective bargaining antedates the factory system by almost a century. There are a number of factors that seem to account for the rise of collective bargaining before the factory system and the machine came in to dominate production. We may mention these factors briefly. The first prerequisite to the existence of collective bargaining seems to be a class of manual laborers who are free men, who work for wages, and who have little hope or expectation that they will ever be anything but wage earners. So long as workers were slaves or serfs, there could, of course, be no possibility of collective bargaining. Nor is collective bargaining likely to develop so long as wage earners have a fair possibility of some day becoming independent entrepreneurs. But when they have lost this hope or expectation of rising out of the wage-earning class, they become interested in joining with other workers to improve their lot *as wage earners.* The loss of such hope was evident in the English economy some 75 years before the rise of the factory system.

But the shift from the domestic system of production to the factory system did give a tremendous impetus to collective bargaining. The rise of large business units, the increased use of machinery, specialization, and division of labor, the loss of ownership of tools and homes, the crowding in large cities, the growth of economic insecurity, of impersonal relations, and of complete dependence upon the job for a livelihood, all tended to develop a sharp class cleavage between the employer and the employee groups and to accelerate greatly the interest of the worker in collective bargaining.

The theory or principle of collective bargaining is said to rest upon economic, political, and sociological bases. Let us take these up one at a time and examine them. First, as

to the economic basis for collective bargaining, it is contended that the weakness of the worker as an individual bargainer under conditions of modern industry necessitates some kind of collective action to prevent unfair treatment by the employer. But this argument logically raises the question: What are the elements in the modern industrial environment that place the individual worker at a disadvantage in bargaining with his employer over the terms of employment?

Bargaining power rests upon the power to withhold. The economic need for collective bargaining thus arises, it is said, from the serious discrepancy in withholding power between the individual employer and the individual employee. Before the rise of the factory system and large-scale business organizations, the process of making the wage bargain was much like that of making any other contract: The worker and his employer came to agreement on the conditions of employment by direct higgling. Between the employer and the employee there existed no wide economic or social gulf, nor was there much difference in knowledge or skill between the two. Usually the result was an agreement which was equitable and mutually satisfactory. That this sort of bargaining no longer exists for the great mass of wage earners in the modern world is, of course, the merest commonplace. Chief Justice Hughes of the United States Supreme Court in a recent decision has stated the case for collective bargaining in modern society as follows: "Long ago we stated the reason for labor organizations. We said that they were organized out of the necessities of the situation; that a single employee was helpless in dealing with an employer; that he was dependent ordinarily on his daily wage for the maintenance of himself and family; that, if the employer refused to pay him the wages he thought fair, he was nevertheless unable to leave the employ and resist unfair and arbitrary treatment; that union was essential to give laborers opportunity to deal on an equality with their employer."

But what are the specific elements in the modern environment that make the individual worker weaker than the employer? Broadly speaking, they are found in the failure of many of the assumptions of free private enterprise. The theory of *laissez faire*, it will be recalled, assumes that certain automatic restraints will always be present in the economic system, sufficient to give every individual or group adequate protection against exploitation or injury by any other individual or group. These automatic restraints were supposed to be provided by the force of competition, backed by market information and an ability and willingness on the part of consumers and wage earners to discriminate between producers. Thus, if all these forces were present and operating in a capitalistic society, it was said that there would be an equality of bargaining power between employers and employees sufficient to allow the individual worker to protect himself against exploitation. But it is another commonplace that many of these as-

sumptions of free enterprise have failed of realization in the actual world.

The increasing size of business units, the increasing use of specialization, division of labor, and automatic machinery have all greatly reduced the economic importance of the individual worker to his employer. Compare, for example, the relative importance of a job to the individual worker with the importance of one man to the employer of thousands. The vastly superior knowledge of the employer with reference to the labor market, labor prices, and labor conditions places the individual worker at a distinct disadvantage in any bargaining relation with his employer. Moreover, the employer is a much more skilled and experienced bargainer than the employee. Bargaining is the everyday business of management,—bargaining for the purchase of raw materials and labor, bargaining for the sale of finished products. Under ordinary conditions the worker cannot be expected to match this experience of the employer. Furthermore, the employer almost always possesses much greater financial resources than the individual worker, therefore the employer has much greater "withholding power." The consequences of failure to reach an agreement in the individual wage bargain are not serious for the employer, but for the employee such failure may mean the difference between self-support and charity.

Finally, two other factors may be mentioned in accounting for the economic weakness of the individual bargainer,—the perishability and immobility of labor and the existence of a large labor reserve. The perishability of labor refers to the fact that labor is a commodity that cannot be stored; it must be used today or today's labor is lost forever. In this sense labor is more perishable than fresh fruit or flowers—a characteristic which obviously greatly reduces labor's "withholding power." The well-known immobility of labor makes the assumption of free enterprise in regard to ability and willingness to discriminate between producers as a protective force appear rather ineffective. Was it not Adam Smith who spoke of labor as the luggage most difficult of all to transport? To the extent that workers cannot freely leave one job and seek another, their bargaining strength as individuals is seriously restricted. The existence of a large labor reserve in any society also tends to cause cutthroat competition among workers for jobs under conditions of individual bargaining. There can be no such thing as equality of bargaining power between employers and employees whenever there are many more men wanting jobs than there are jobs wanting men.

Because of all these factors in economic society, therefore, which tend to place the individual worker at a hopeless disadvantage in bargaining with his employer, it is insisted that collective bargaining must be substituted for individual bargaining if anything like equality is to prevail in negotiating the wage contract. It should be emphasized, however, that the theory of collective bargaining does not contem-

plate shifting the balance of power to the employees, although it has wrongly been regarded by some as inevitably resulting in such a shift. By those who hold this view, collective bargaining has been represented as giving the employee an overpowering advantage over the employer. But what is forgotten in reaching such a conclusion is that in the absence of collective bargaining the situation is normally one in which the employer has just such an advantage over the employee.

The political basis for collective bargaining is said to be an outgrowth of the widespread acceptance during the 19th and early 20th centuries of the democratic philosophy of government. The basic theory of democracy, as we all know, stems from the principle that government should rest upon the consent of the governed; that everyone should have an equal voice in the determination of the rules and conditions under which we live. If we accept political democracy as the only fair and just device for determining the rules under which we live, the question then arises as to how this is to be reconciled with industrial autocracy,—i.e., the denial of the right of workers to a voice in the determination of working conditions through collective bargaining? In other words, if political democracy is right and just *in principle,* is not industrial democray defensible on the same ground? In support of this contention that workers should have some voice in the determination of wages, hours, and working conditions, the cooperative nature of production is also stressed. In economics we speak of land, labor, capital, and management as being the cooperating factors of production,—equally important and indispensable in the production of economic goods. To say then that one factor is more important than any other, and should therefore be given the sole right to determine working conditions, is equivalent to saying that one leg of a three-legged stool is more important than either of the other two.

The sociological basis for collective bargaining may be stated very briefly. It stresses the fact that workers are human beings, that as a class they constitute a large proportion of society, and that to the extent that collective bargaining offers any possibility of raising the living conditions and standards of this class it is socially desirable. This of course implies that it is socially undesirable to leave the economic fate of employees wholly in the hands of their employers.

The potential benefits claimed for collective bargaining are many. If the discussion thus far has seemed to imply that employers generally are opposed to collective bargaining such has not been the intention, nor is such the case. Many employers favor collective bargaining because they believe it "pays" in dollars and cents. Among the potential employer benefits frequently cited as evidence that collective bargaining "pays" are the following: (1) the standardization and stabilization of competitive conditions in the industry, (e.g., the clothing industry); (2) a reduction of labor turnover; (3) the good will and co-

operation of employees rather than the ill will, the sabotage, restriction of output, and costly interruptions to production which are characteristic practices of dissatisfied workers.

The potential employee benefits from collective bargaining are said to include the following: (1) a larger share of the national income; (2) elimination of ruinous competition for jobs among workers; (3) a voice in the determination of wages, hours, and working conditions; (4) increased job protection and security, (i.e., protection against arbitrary discrimination and discharge).

Lastly the potential social gains claimed for collective bargaining include: (1) a reduction in industrial conflict and social waste; (2) more goods, and goods of better quality, at possibly lower selling prices; (3) a happier, more contented working population,—a labor force less susceptible to radical doctrines and propaganda, and hence less of a risk to modern capitalistic systems.

It will be noted in the above enumerated claims for collective bargaining that the word "potential" has been used freely. It is not contended in this article that all the benefits mentioned *will* be realized in every instance, or even necessarily in a majority of instances, but it is merely pointed out here that they are *potential* advantages that may accrue from the full and free acceptance of the principle of collective bargaining.

But it is commonly said that it is one thing to build up a nice body of theory to support a given proposition, and quite another thing to put this theory into practice. What can be said of the practice of collective bargaining? The objectives of collective bargaining as practiced in the American scene are distinctly conservative rather than revolutionary. American trade unions seek more here and now for their members, within the framework of the capitalistic system, rather than the revolutionary overthrow of this system. And this conservative objective is reflected in their practices. The practices or methods of collective bargaining stress four major points. First, recognition of the union. Obviously, there can be no such thing as collective bargaining until and unless the collective bargaining agency is recognized as a legitimate and necessary institution. Second, standardization of wages, hours, and working conditions,—considered indispensable in eliminating cutthroat competition among employees and among employers. Third, representation of the workers by independent negotiators,—also considered indispensable if effective and equal bargaining power is to be realized. And finally, the collective trade agreement in which the terms of employment are recorded in specific language.

In examining the practices of collective bargaining, the point is further stressed that the protective devices of collective bargaining are not needed, and ordinarily not used, if the four above-mentioned practices are operating. This means that such trade union protective practices or policies as the closed shop, restriction of output, strikes, boycotts,

and picketing are ordinarily resorted to only when some or all of the four major methods outlined above have failed. The popular opinion that a trade union is functioning only when it is striking is a most erroneous one. As a matter of fact strikes, boycotts, picketing, etc., indicate that collective bargaining has broken down and that resort is now had to force. They do not represent the normal, everyday practices of collective bargaining; instead they represent the malfunctioning of collective bargaining, the abnormal situation.

No discussion of the practices of collective bargaining, however, can ignore the abuses which periodically crop out. When power becomes overbalanced on the side of labor, abuses are just as common, and just as much to be expected, as when power is overbalanced on the other side. Labor racketeering, collusion, and graft, exploitation of employers, employees, and the public by unscrupulous and dishonest labor leade are all too common in many local ties and deserve the full condemna tion of society. Such anti-soci practices should be stamped out a vigorously and ruthlessly as ant social practices found operating i any other phase of economic lif Irresponsible action by trade union due either to a lack of discipline o the part of the rank and file, or t the lack of well-trained, responsibl labor leaders, is another practic that must be eliminated if collectiv bargaining is to win and hold th respect of the public. Such irre sponsible action results in seriou losses to employers, employees, an the public. The recent "wild cat strikes in the automobile industr might be cited as an example. Bu in conclusion it is suggested tha even grave abuses in any give segment of economic life may not b sufficient to condemn a principle and this may well apply to th principle of collective bargaining.